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General Business Conditions

THE business news during July has borne out indications that began to appear in June that the hand-to-mouth buying policies and reduction of inventories since the first of the year were clearing the way for an upturn of demand in many lines. For the first time since the slump set in, buying in substantial volume appeared in nonferrous metals, primary textiles, and various other industries, bringing firmer prices in numerous cases and a better feeling throughout business generally.

In nonferrous metals, which had fallen sharply in price, copper and zinc quotations were marked up twice — copper from 16c to 17⅝c, and zinc from 9c to 10c — while lead prices were raised five times from 12c to 14½c; and buying continued strong at the higher levels. According to trade estimates, copper and zinc producers doubled their sales volume as compared with recent monthly lows, while lead producers sold as much during July as they had in the four preceding months of price weakness.

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The upturn in lead sales is closely associated with the marked improvement in the storage battery business, and illustrates what has been happening quite widely throughout business as a result of the holding off for lower prices and the urge to reduce inventories. During the early part of the year battery shipments had fallen to low ebb, reflecting the trade reluctance to accumulate stock. But as the use of batteries in new motor car production, and in old cars on the road, continued at a record-breaking rate, we now have the situation described by Royce G. Martin, president of Electric Auto-Lite, in which "a demand that threatens to outrun production is being experienced by this country's automobile storage battery business". Sales in June, Mr. Martin stated, were 44 per cent greater than the average for the five preceding months and the rising trend continued in July. Thus, battery manufacturers, who like everyone else had been trying to reduce stocks, suddenly found themselves short of lead and having to cover with heavy purchases. In a short time the situation was reversed all along the line.

Textiles Improve

Cotton textiles, one of the first industries forced to readjust, have likewise taken a turn for the better. With raw cotton prices down to the new crop basis, buyers stepped into the primary goods markets for the largest purchases in over a year, bidding up prices a half cent or more a yard on some constructions. With their output generally sold into September, mills are now reluctant to extend commitments further ahead at present narrow operating margins, even though some buyers are reported as trying to place orders as far ahead as December. Mill consumption of raw cotton, which had been heavily curtailed, showed a counter-seasonal increase in June.

Other major lines reporting stepped up buying include rayon, shoes, clothing, paper, some building materials and chemicals, and flour milling. Many individual companies in various fields have

strengthened their position by cutting costs and intensifying sales efforts.

In short, for a good many industries and companies which have gone through substantial price and production readjustment, the feeling prevails that a real corner has been turned, provided no further serious deterioration is encountered in the general situation. What everyone wants to know, of course, is whether incompleted adjustments in other lines, or some unexpected shock, might set off another downward spiral. It is noted that signs of improvement are by no means uniform, and that thus far the steel industry, which perhaps more than any other constitutes both the backbone and barometer of American heavy industry, has yet to register a "turn". While the decline in steel mill operations was checked at around 80 per cent of capacity in July, the threats of either a steel strike or coal strike have been temporary supporting influences upon buying, and the industry generally expects production to dip lower before the year-end.

Building construction and automobile production continue to give strong support to business generally. Construction contract awards during June and July held close to the high figures of a year ago, the rising trend of federal and local government awards offsetting some tapering off in private residential and industrial construction. Motor car assemblies during July broke all previous records for that month.

Purchasing Power Still High

The prolonged boom in the motor industry, which has confounded the pessimists, reflects the continued high purchasing power of the American people despite a moderate increase in unemployment and curtailment to part-time operations in various industries. The latest Department of Commerce report on total personal incomes for May was at an annual rate of $212 billion (seasonally adjusted), or only 2 per cent less than the all-time peak last December. June sales of all retail establishments were estimated by the Commerce Department at barely 2 per cent under a year ago which, with allowance for lower prices, means actually a larger volume of goods and services.

This high and sustained rate of people's income and consumption, while overall production as measured by the Federal Reserve index has gone off some 13 per cent from last year's peak, is the kind of thing that can set the stage for recovery, provided new developments of an unfavorable nature are avoided.

In this situation, the most disturbing domestic element is the demand for further wage increases, carrying the threat of higher costs and a reversal of the decline in prices which consumers generally have been hoping for. How much better if the benefits of modernized and expanded plant facilities and lowered costs for numerous raw materials can, with increasing competition, be passed on to the public at large in lowered prices of finished products, rather than monopolized by a comparatively small group of organized workers. With the postwar price inflation checked, the last thing we want now is any action that would force new increases in costs and selling prices, and risk curtailing consumption.

The President's Economic Report

With uncertainty over the business outlook the number one domestic question disturbing the American people, the President's midyear economic report, together with the midyear report of his Council of Economic Advisers, transmitted to Congress last month, had been awaited with unusual interest by the business community.

Actual publication of both documents revealed much that was reassuring. The President's change of heart in the matter of taxes, and his decision not to press for the $4 billion increase previously insisted on, was welcomed. While the evident lack of enthusiasm on the part of Congress for the President's former tax program had made it seem unlikely to go through, nevertheless his persistence in urging it was disturbing to business and to investors.

Business was also favorably impressed by the calm tone of the President's report, and its eschewal of radical proposals. It was noted with approval that the President did not follow the lead of those who are clamoring for a new round of wage increases, or for a vast program of public works, to "increase purchasing power." His advocacy of repealing the tax on transportation of goods and of liberalizing provisions for carry-over of losses by corporations was regarded as recognition of the need for encouraging business.

A "Transition Period"

The keynote of both the President's report and that of the Council of Economic Advisers is found in the President's characterization of the present as a "transition period" in business. Repeatedly, in his report to Congress and in his subsequent radio talk to the nation, he emphasized the generally mild and orderly character of the readjustment. "Our economy," he declared, "is still operating at high levels of employment and production . . . We are not in a depression."

The same theme runs through the report of the Council of Economic Advisers. While not ignoring the hazards of further recession, the

report leans to the side of restrained optimism. Reviewing the factors of weakness and strength in the situation, it says:

It was not to be expected that all of these adjustments could take place without any temporary slaekening of employment and production . . . Many factors auger well for the successful culmination of the readjustment process in early stability followed by renewed growth . . . Production, which on account of inventory reduction has fallen below the rate of sales in many lines, should before too long come back at least into line with current sales if nothing occurs to create more pessimistic anticipations.

In sum, the report concludes, "we find the prospect reassuring."

In these circumstances, the President concedes that "the kind of government action that would be called for in a serious emergency would not be appropriate now." However, he goes on to say:

It would be even less appropriate to rely entirely on "letting nature take its course". . . The life and spirit of the American economy is progress and expansion . . . We can achieve within a few years a national output well above 300 billion dollars, valued at current prices . . . The tools are at hand for continued economic expansion. All we need is the courage to use them.

What, then, are the tools which the President has in mind?

What Business Should Do

First, we must have an expanded level of private investment. This recognition in the report of the importance of a flow of private capital into industry in maintaining employment and purchasing power is especially notable in view of all that is heard these days about the need for "distributing" profits through wage increases, and engaging in government "pump-priming" expenditures, in order to spread buying power and stimulate consumption.

Paying tribute to American business "initiative, ingenuity and courage" that accomplished a "miracle" of production during the war, the President urged business to take advantage of—

the great opportunities to remove obsolescence, to make use of the rapid progress of science and invention, to improve transportation facilities, to enlarge the housing supply, to industrialize underdeveloped areas of our country, to bring conveniences and labor-saving devices to American homes and farms, and to meet the needs of a population that will continue to grow.

Secondly, business should seek to maintain production and sales by cutting prices "even at the cost of temporarily reduced profits." But don't cut wages. "Business cannot be prosperous unless the purchasing power of workers is maintained."

Back to Deficit Financing

The third "tool" that the President talks about is deficit financing. Taking cognizance of the fact that the Treasury is already operating in the red, he asserts:

If we tried to avoid a budget deficit by cutting essential expenditures, we would contribute to lower national output and low employment. Federal receipts would fall further, and the burden upon federal expenditures would increase. We cannot expect to achieve a budget surplus in a declining national economy.

The President blames the present Treasury deficit primarily on the "untimely tax reduction of five billion dollars during the height of the inflation." This, he says, "has been aggravated by the loss in revenue resulting from the decline in production and national income." He neglects to point out that federal expenditures have increased from $34 billion in the fiscal year 1948 to an estimated $42 billion in fiscal 1950 (January budget), or by $8 billion. And the 1950 figure does not allow for the proposed military aid program, nor for other costs, including farm price support, looming larger than anticipated.

Despite the prospective deficit, the President sees no need to trim down the spending. On the contrary, his emphasis is all on constantly expanding programs of federal expenditure. To quote from his radio speech:

We must therefore press forward with programs of soil conservation, and river development, and public works. Economic expansion requires constantly rising living standards for our people. We must therefore expand our programs for social security, education, health and housing. We must build, as we are building, for the future.

The President defended his 42 billion budget by the familiar technique of treating the four major categories of expense—national defense, international aid, interest on the national debt, and veterans expenditures, all footing up to $32 billion, or around three-quarters of the budget—as untouchable; then implying that the remaining $10 billion is too small to get excited about. The fact is that these major items cover up a "multitude of sins," as the Hoover Commission has made clear, and as the President himself has pointed out from time to time.

But the central point of the President's argument against cutting the budget is that to do so now, when private spending is showing some moderate decline, would accelerate deflationary tendencies.

We ought to consider carefully what this means. Here we are with an economy that is "still operating at high levels of employment and production . . . We are not in a depression." These are the President's own words. Yet "we cannot expect" to balance the budget.

It is, of course, the essence of the "compensatory budget" theory that the Government should

"prime the pump" by deficit spending and expansion of debt in time of depression, and should reverse the process by over-balancing the budget and retiring debt in time of prosperity. It is one thing, however, to countenance deficit spending in time of real depression, and quite another to embrace it in an effort to maintain a perpetual boom.

If we accept the philosophy that we cannot afford to balance the budget except at the peak of the business cycle, then plainly the budget will remain unbalanced most of the time. The occasional surpluses will be offset many times over by the succession of deficits, and the debt, instead of being reduced, will mount higher and higher. How long we could keep this up is impossible to say, but history is full of examples of the wreckage of currency systems resulting from such improvident policies.

Legislative Proposals

The President's report also carried eleven recommendations for Congressional action deemed of "vital importance" in the current economic situation. These were, in brief:

(1) Repeal tax on transportation of goods, liberalize tax provision for carry-over of corporate losses, and increase estate and gift taxes. No other major tax increase. (2) Extend time limit on maturity of business loans by Reconstruction Finance Corporation. (3) Provide for study of investment and needs for developing an expanding economy. (4) Adopt improved farm income supports (the Brannan plan). (5) Increase minimum wage to 75 cents an hour and broaden coverage. (6) Increase unemployment insurance benefits and extend coverage. (7) Extend veterans' readjustment allowances to July 25, 1950. (8) Increase old-age benefits and extend benefits; improve public assistance program. (9) Intensify advance planning of public works. (10) Enact legislation to provide technical assistance to underdeveloped areas abroad and to encourage investment in such areas. (11) Restore Reciprocal Trade Agreements Act.

Apart from the recommendation of no major tax increase, and the gesture embodied in the proposals regarding transportation taxes and carry-over loss provisions in corporation taxes, there appears little in this program to encourage the dynamic forces of the economy on which real progress depends.

The proposed raising of estate and gift taxes means a further squeezing of one of the sources of equity capital.

The proposed extension of the maturity limit on business loans by the RFC would put that organization in the position of furnishing what is tantamount to permanent equity capital. It would mean, likewise, the subsidizing of inefficient and inadequately capitalized concerns at the expense of sound businesses which would have to meet this competition.

The minimum wage proposals, while not likely to touch many workers in the major industrial and commercial centers, most of whom are already getting well above the 75 cents an hour rate, would raise costs for some smaller industries in rural communities where both rates of pay and living costs are below the national average. They would probably mean transferring to the public relief rolls numerous workers who might otherwise be self-supporting.

Managed vs. Free Economy

There can, of course, be no disagreement with the President's statement that "economic expansion requires constantly rising living standards of our people." But the question is, how do you get this — by government planning and direction, or by giving maximum scope to those dynamic natural forces which have brought us the great gains we have had in the past? In his radio address the President said:

> The history of the United States is a story of constant economic growth and expansion. When I was a young man the population of the United States was between 90 and 100 million. Today it is nearly 150 million. Forty years ago, the national income — the total of all income received by all the people in the United States — was in the neighborhood of 30 billion dollars. Today, the national income is well over 200 billion dollars. It has increased more than ten times as fast as the population.
>
> These figures are a measure of our rising standard of living — our increasing freedom from toil and poverty. They are the result of constant expansion in agriculture and industry.

By way of qualification it should be said that the change in the national income also reflects price inflation, the direct product of government spending in two wars. It is not all gain, for many people have lost heavily through inflation.

It might also be added that the great gains were accomplished largely in an era before "big government" undertook to manage our lives. As the President tells us in one of the passages cited earlier, the potentialities for growth and development of this country are still enormous. At the same time, "the life and spirit of the American economy is progress and expansion". What reason, then, to doubt that the same business "initiative, ingenuity, and courage", which he extols for their accomplishments during the war, and which have been so effective in promoting our past growth, can carry us on to still higher goals, provided a climate generally favorable to enterprise is preserved?

We shall do better as a nation if the Government does its own job of fiscal management and good housekeeping better and allows its citizens their traditional freedom to invent, to initiate,

and to carry forward the activities in which this country has made unique progress.

The Half Year's Earnings

Reports issued to date by 545 leading corporations in the manufacturing, mining, trade, and service industries show that earnings in the first half year were, in a majority of cases, substantially lower than in the first half of 1948. About two out of three companies were down as compared with the first half of last year, while three out of four were down as compared with the second half. The declines in earnings were usually much sharper than the declines in volume of sales, which were relatively well maintained, indicating that profit margins were squeezed by the pressure of high costs of production and distribution, as well as by lower selling prices and inventory write-downs.

Due, however, to the record production in the steel and automobile industries, the combined earnings for the group as a whole were down only 5 per cent from the first half of 1948, and down 14 per cent from the second half. Excluding the steel and automobile groups, earnings of the remaining 498 companies were 19 per cent below the first half of last year, and 22 per cent below the second half.

Quarterly Trend Downward

Separate figures available by quarters for 451 companies indicate that most of the decline in earnings this year occurred during the second quarter. Whereas the first quarter showed a combined total for the group 2 per cent below the first quarter of 1948, the total for the second quarter is down 11 per cent from the preceding quarter, and 9 per cent from the second quarter of 1948, as may be seen by the following comparison of quarterly figures:

Quarterly Net Income of 451 Leading Corporations

(In Millions of Dollars)

Quarter	1948	1949	% Change
First	$962	$943	—2
Second	921	840	—9
Third	980		
Fourth	1,098		

Here again the totals are heavily weighted by the steel and motor groups, without which the second quarter total was 25 per cent below that of a year ago.

In the steel industry, which in the first half year achieved an increase of 7 per cent in output to a new high record of almost 46,000,000 tons of ingots as a result of full operations and expanded plant capacity, the reports of 35 companies showed for the half year an increase in net earnings of 50 per cent over the same period of 1948. The second quarter earnings, however, fell 25 per cent below those of the first quarter this year as a result of slackened demand for steel, curtailed operations, price reduction on some finished products, and continued high costs. Expectations are that operations during the second half of this year will run substantially below the high levels of the corresponding period last year.

NET INCOME OF LEADING CORPORATIONS FOR THE FIRST HALF YEAR

(In Thousands of Dollars)

No. of Cos.	Industry Groups	Reported Net Income: 1st Half 1948	Reported Net Income: 2nd Half 1948	Reported Net Income: 1st Half 1949	Per Cent Change From: 1st Half 1948	Per Cent Change From: 2nd Half 1948
35	Food products	$ 108,800	$ 122,967	$ 103,602	— 4.8	—15.7
14	Beverages	42,133	52,711	39,224	— 6.9	—25.6
36	Textiles and apparel	102,714	82,499	37,383	—63.6	—54.7
20	Pulp and paper products	49,570	45,973	27,962	—43.6	—39.2
35	Chemicals and paints	178,690	223,911	192,165	+ 7.5	—14.2
9	Drugs, soap, cosmetics	12,026	12,608	15,407	+28.1	+22.2
17	Petroleum products	638,719	573,081	465,665	—27.1	—18.7
21	Cement, glass, and stone	50,308	60,240	51,237	+ 1.8	—14.9
35	Iron and steel	212,634	320,982	318,595	+49.8	— 0.7
20	Electrical equipment and radio	107,397	124,638	97,958	— 8.8	—21.4
45	Machinery	51,765	71,682	56,051	+ 8.3	—21.8
9	Office equipment	30,938	32,726	29,833	— 3.6	— 8.8
12	Autos and trucks	234,506	264,977	334,440	+42.6	+26.2
29	Automobile parts	46,896	61,050	47,348	+ 1.0	—22.4
11	Railway equipment	20,658	21,086	22,792	+10.3	+ 8.1
78	Other metal products	103,429	113,602	66,819	—35.4	—41.2
36	Miscellaneous manufacturing	64,506	76,090	58,982	—16.3	—29.1
462	Total manufacturing	2,055,689	2,260,823	1,960,458	— 4.6	—13.3
37	Mining and quarrying	85,582*	91,446*	68,284*	—20.3	—25.4
28	Trade (retail and wholesale)	35,530	42,121	30,122	—15.2	—28.5
18	Service industries	13,649	16,935	14,917	+ 9.3	—11.9
545	Total	$2,190,450	$2,411,325	$2,073,731	— 5.3	—14.0

*Before depletion charges in some cases.

The Under-Depreciation of Corporate Assets

Discussions of corporation earnings reports in recent years have repeatedly emphasized the overstatement of real corporate income which results from the inadequacy of current depreciation charges to provide for the replacement, at present costs, of the plant and equipment which is being used up in current production. According to usual — although recently much debated — accounting practice, annual depreciation charges, which are deducted from earnings for the purpose of amortizing the value of fixed assets during their estimated useful life, are based upon original costs of plant and equipment. But the cost of replacement today is far above original cost. Hence current depreciation charges are in most cases at a rate far below the amounts now needed to build or purchase similar assets.

This inadequacy of depreciation charges causes an overstatement of "net income." In effect what has happened is that business has been selling out its low-cost productive assets piecemeal, and has been taking the "profit" into operating income, and paying taxes on it, without adequate provision for replacement.

In connection with our studies of corporation earnings for the year 1948, we have now tabulated gross and net book valuations of plant and equipment and 1948 depreciation charges of 2,601 of the larger corporations, covering all lines except banking, insurance, investment, finance, and real estate. This tabulation, given in the accompanying summary, covers the same companies for which we gave in the April 1949 issue our regular annual summary of earnings, return on net assets, and profit margin on sales.

What the Figures Show

The gross property account reported by these corporations at the end of 1948 totaled approximately $113 billion, while accrued reserves for depreciation (including also depletion and amortization, if any) totaled $42 billion, leaving a net property account of $71 billion. Last year's depreciation charges totaled $3.8 billion, which represented a rate of 3.4 per cent on the gross property valuation. This rate indicates that property assets were being depreciated on the basis of an average life of approximately thirty years. Many manufacturing companies charge off plant and equipment at much faster rates than do the railroads and public utilities, which together make up more than half of the total net property account in our tabulation.

According to past relationships, this sample may be assumed to represent approximately half of the book valuation of the entire industrial plant of this country. Thus it provides a basis for an estimation of the extent of the inadequacy

Property Accounts and Depreciation Reported by Leading Nonfinancial Corporations in 1948

(In Millions of Dollars)

No. of Cos.	Industrial Groups	Gross Property Account	Reserve for Depreciation*	Net Property Account	1948 Depreciation Charges*
24	Baking	$ 453	$ 193	$ 260	$ 19
17	Dairy products	620	255	365	34
21	Meat packing	774	334	440	30
23	Sugar	442	196	246	12
75	Other food products	1,269	545	724	43
17	Soft drinks	207	63	144	10
31	Brewing	272	78	194	5
11	Distilling	289	91	198	14
23	Tobacco products	241	101	140	9
40	Cotton goods	466	202	264	10
17	Silk and rayon	596	269	327	29
7	Woolen goods	108	51	57	3
18	Hoisery, knitd. gds.	94	42	52	4
46	Other textile prod.	622	269	353	20
83	Clothing & apparel	92	41	51	3
9	Leather tanning	32	16	16	1
25	Shoes, leather prod.	137	71	66	7
25	Tires, rubber prod.	1,096	632	464	61
29	Lumber	295	112	183	15
17	Furn., wood prod.	133	50	83	6
85	Pulp & paper prod.	2,008	816	1,192	69
31	Printing & publish.	238	103	135	7
65	Chemical products	3,601	1,639	1,962	188
29	Drugs, soap, cosmet.	486	171	315	18
17	Paint and varnish	275	108	167	10
44	Petroleum products	17,742	8,602	9,140	815
28	Cement	425	245	180	11
12	Glass products	505	222	283	18
40	Other stone, clay prod.	702	261	441	28
53	Iron and steel	7,254	3,929	3,325	300
11	Agriculture imple.	742	265	477	33
77	Bldg., heat., equip.	548	248	300	22
79	Elec. equip.& radio	1,639	806	833	85
46	Hardware and tools	287	144	143	9
43	Household appliances	238	102	136	10
156	Machinery	886	415	471	35
25	Office equipment	487	203	284	32
34	Nonferrous metals	2,556	1,257	1,299	55
94	Other metal products	1,051	459	592	42
28	Autos and trucks	2,341	1,138	1,203	153
66	Automobile parts	655	246	409	36
25	Railway equipment	678	350	328	20
25	Aircraft and parts	227	123	104	7
6	Shipbuilding	67	37	30	1
53	Misc. manufacturing	563	242	321	9
1,680	Total manufacturing	54,435	25,740	28,695	2,345
33	Coal mining†	1,004	440	564	30
26	Metal mining†	342	173	169	10
44	Oil and gas†	880	422	458	37
12	Other mining, quar.†	127	59	68	5
115	Total mining, quar.†	2,354	1,095	1,259	83
20	Chain stores—food	199	75	124	14
61	Chain stores—other	757	229	528	37
43	Department stores	700	212	488	27
7	Mail order	374	161	213	27
62	Wholesale and misc.	403	166	237	17
193	Total trade	2,432	841	1,591	121
131	Class 1 railroads	23,489	6,006	17,483	392
33	Traction and bus	858	268	590	23
12	Shipping	312	79	233	12
16	Air transport	363	123	240	46
51	Misc. transportation	535	239	296	12
243	Total transportation	25,558	6,715	18,843	485
196	Elec. power, gas, etc.	17,543	4,000	13,543	395
66	Telephone & telegr.	9,515	2,831	6,684	311
262	Total public utilities	27,058	6,831	20,227	707
14	Amusements	405	145	260	11
45	Restaurant & hotel	260	101	159	8
36	Other business services	140	60	80	15
19	Construction	85	36	49	2
108	Total amuse., ser., etc.	890	342	548	35
2,601	Grand total	$112,725	$41,563	$71,162	$3,777

*Includes also depletion and amortization, if any. †Reported before depletion charges in some cases.

of depreciation which may be considered applicable to the whole of American industry.

The property currently carried on the books of these corporations at $71 billion cost originally $113 billion. The average cost of industrial and commercial building, during the thirty years over which this plant has been constructed, may be roughly measured by an index of building costs computed by the Engineering News Record, which is widely used as an indication of overall trends. From 1919 through 1948 this index averaged 199.5 (based on 1913 = 100), and if weighted according to expenditures each year for new plant and equipment averaged 213. The index for the year 1948 was 345, or 62 per cent above the thirty-year weighted average.

While no single index can accurately represent the cost of all the varied items covered in "plant and equipment", it may be estimated from these relationships that the cost of reproduction now of American industrial plant in 1948 was in the neighborhood of 62 per cent above its weighted average original cost; or, in other words, that the property of the 2,601 corporations tabulated would have cost over $180 billion to replace in 1948. The accrued depreciation to date of $42 billion which has been set aside out of earnings should really be $68 billion on the same basis, a shortage of $26 billion.

To accumulate $180 billion during a thirty-year average life, annual depreciation would have to reach $6.0 billion, as against the $3.8 billion actually charged in 1948, based on original cost.

An Erosion of Capital

This calculation indicates that 1948 depreciation of these companies fell $2.2 billion short of recovering the current dollar cost of making good their annual wear, wastage and obsolescence. Doubling the sample figure to cover all the American industrial plant, the estimated deficiency would be $4.4 billion, which, unless earned, represents erosion of capital.

For the three years since the war, there was for all American corporations a deficiency of depreciation charges of perhaps $12 billion. The effect of this understatement was to exaggerate reported earnings before taxes by an equal amount. At the same time, as the Department of Commerce recognizes in its profits computations, the earnings included the effect of inventory price increases of $13 billion, making a combined total of $25 billion in unreal "profits".

In some cases corporations set aside reserves to be used for replacement purposes, and in their published statements made appropriations from earnings for these reserves, even though required by the U. S. Treasury to pay income taxes on the amount. Except as depreciation accounts were augmented by such charges, however, earnings were overstated, and the overstatement reflected simply the amount of plant and equipment used up at prices far below replacement costs.

These estimates obviously are approximate and subject to several qualifications. In calculating the thirty-year weighted average cost used as a base, it was assumed that annual expenditures for plant and equipment by the 2,601 companies were in proportion to such annual expenditures for all business as reported by government agencies, which leaves room for some distortion. The index of building costs may not fully represent changes in equipment prices. The figures include land which is not customarily depreciated and will not have to be replaced. This is not a large element. The book valuations in the accounts are not always uniform, for accounting concepts and practices vary.

But even with allowance for any defects in the figures, and without straining the argument, they demonstrate the dimensions of this much discussed problem. They show that depreciation currently charged against earnings falls short by a wide margin of supplying the funds necessary for the replacement of the wasting assets. They illustrate why corporations have had to retain an abnormally large percentage of their reported "net income" for re-investment. Our conventional accounting practices, influenced as they are by our tax regulations, simply cannot be relied upon as a safe guide of what earnings there are available for capital expansion and improvement. This needs to be borne in mind in judging current levels of reported earnings, the repeated attacks upon business for "profiteering", and recurring demands for increased wages.

Urgency of the Problem

The capital required to finance industrial replacements at present prices, over and above that provided by depreciation reserves based upon the recovery of original costs only, can be obtained only from three principal sources – reinvested earnings, borrowing, or sale of additional stock. All three require that business make good earnings, without which there would be nothing to reinvest, and no basis for getting either loans or equity money. In many cases the future capital requirements are so heavy that the maintenance of merely a "reasonable" level of earnings (whatever that may be) is not enough; there must be a considerable margin over that yielded by riskless bond investment.

Since plant expansion and replacement is a continuing process, the problem will be present until corrective measures are taken. Several foreign countries have recognized this inadequacy of conventional accounting by permitting a stepping up of depreciation charges allowable for tax purposes. Even if prices should level off, the outlay for new facilities in coming years will be far greater than the amount set aside to replace them under present inadequate accounting methods and restrictive tax regulations.

Finally, there should be some margin of earnings, over and above that required for merely maintaining the physical condition of the country's industrial plant and machinery, to finance long-term growth. During the ten years since 1939 the population has grown from 131 million to nearly 150 million. The unparalleled progress made in raising the American standard of living by expanding production and lowering costs has been made possible only by an economic system that has constantly attracted a stream of new investment capital into power equipment for making work easier and more productive — in factories and public utility plants, on farms and railroads, in offices and in homes. Not only is this needed for supplying the wants of the people, but the very security of the nation depends upon it, as was demonstrated so effectively during the last war.

Impact of New Credit Policy

Developments in July cast light on the significance of the new Federal Reserve policy announced on June 29, which changed the system of "price controls" on government securities operative since 1942. The bond market, which in recent months had been held down by price stabilizing sales out of the Federal Reserve portfolio, responded to the statement with eager enthusiasm. It was plainly evident that the authorities wanted to make credit easier, and the only question was how the new policy would be implemented, especially in light of the impending drop in member bank reserve requirements. The "supplemental" reserve requirements, imposed last September and partly rescinded in May, were scheduled to lapse entirely on June 30 and release about $800 million bank funds for lending or investing.

What the Federal Open Market Committee did at this juncture was to withdraw entirely from the government security market. No effort was made to supply securities in which the banks could put to work their newly-released funds. Under the circumstances the $800 million piled up excess reserves, which rose from $640 million on June 29 to $1,410 million on July 6.

The reaction on security yields and prices was swift, as banks with idle funds competed for what offerings appeared on the market. Treasury bills, which had been stabilized by the Federal Reserve on a 1.15 or 1.16 per cent yield basis for the previous seven months, temporarily were bid up to prices which brought the yield below 0.90 per cent, and 1¼ per cent Treasury certificates of indebtedness rose to premiums which reduced available yields to around 1 per cent. Rates on bankers acceptances were shaved ⅛ to ¼ per cent, depending on maturity.

Indeed, for a brief time the market for short-term government paper verged on the disorderly and a reasonable equilibrium was restored only after the Federal Reserve authorities, during the second and third weeks of the month, sold or let mature substantial amounts of Treasury bills and certificates from their portfolio. These operations cut back the volume of excess reserves to around $950 million which is still about $200 million higher than the average level of the February to June period. Yield rates on bills and certificates firmed again and appeared to be establishing a new level around one per cent for bills and 1.04 to 1.08 for 1-year certificates.

The Federal Reserve restricted its operations under the new policy to short-term government paper. In government bonds the Committee maintained a "hands-off" policy and allowed their announcement, and the simultaneous rise in excess reserves, to have their full effects. The demand for corporation and municipal obligations, already strong, was further stimulated. On long-term taxable Treasury bonds, prices advanced a full point or better, cutting yields realizable to the purchaser by around ⅛ per cent.

The following table compares yields on various classes of securities on July 29 with those prevailing on June 28, before the policy statement became public, and on June 30 of 1948 and 1947.

Yields on Selected Securities

	July 29, 1949	June 28, 1949	June 30, 1948	June 30, 1947
Long-Term Corporate				
Aaa corporate bonds*	2.64%	2.71%	2.77%	2.56%
Baa corporate bonds*	3.44	3.48	3.35	3.21
High grade preferred stocks†	3.94	3.97	4.07	3.75
Long-Term Government				
High grade municipal bonds†	2.25	2.29	2.31	1.91
Victory Loan 2½s, Dec. 1967-72	2.34	2.44	2.48	2.33
Bank eligible 2½s, Sept. 1967-72	2.16	2.22	2.37	2.16
Part. tax-exempt 2¾s, Dec. 1960-65	1.51	1.54	1.86	1.59
Intermediate and Short-Term Govt.				
September 1956-59, 2¼s	1.54	1.62	1.96	1.65
December 1952-54, 2s	1.27	1.40	1.60	1.44
1-year certificates	1.04	1.20	1.09	0.85
91-day Treasury bills (new issues)	1.02	1.16	1.00	0.38

*Moody's Investors Service. †Standard & Poor's Corporation (figures are for last Wednesday in each month).

Aided by the exceptionally favorable market conditions, and following an unusually heavy second quarter, offerings of corporate, State and municipal bonds continued to come out in large volume during July. Indeed, on the basis of the first seven month's record, this year bids fair to equal 1948 in the volume of new money raised through corporate bond flotations. The same holds for the States and municipalities where postwar construction programs are being financed through the sale of serially maturing bonds. The following table compares security issues for purposes of raising new capital for the first six months of 1949, 1948, and 1947.

New Security Issues for Purposes of Raising New Capital
(In Millions of Dollars)

	First Six Months		
	1949	1948	1947
Corporate			
Railroads	$ 288	$ 258	$ 103
Public utilities	1,730	1,427	698
Industrial and manufacturing	771	636	689
Oil	180	391	127
Other corporate	267	352	267
Total corporate	$3,236	$3,064	$1,884
State and municipal	1,410	1,582	1,327
Total corporate, State and municipal	$4,646	$4,646	$3,211

Source: Commercial and Financial Chronicle.

Bank loans to business continued to shrink during July although the rate of decline slackened. For the weekly reporting member banks, the contraction in business loans so far this year now has run beyond $2½ billion – three times the expansion that occurred during 1948. One substantial factor in the decline, aside from inventory reductions and price declines, has been a refunding of bank loans out of the proceeds of new bond issues, a substitution of long-term for short-term debt. Seasonal forces, which come into play in the second half of each year, should have an influence in sustaining loan volumes in the months ahead. Banks continue sizable purchases of State and municipal obligations.

Implications of New Policy

The emphasis laid, in the new policy statement, on the general business and credit situation as the primary consideration determining Federal Reserve open market operations, represents a return by the Federal Reserve System to its traditional role as an influence toward economic stability. As a matter of fact, before December, 1941, there was never any question but that "the general business and credit situation" was supposed to be the principal determinant of Federal Reserve open market policy. Section 12A of the Federal Reserve Act, with reference to open market operations conducted by the Federal Open Market Committee, stipulates that:

> The time, character, and volume of all purchases and sales (of government securities and other paper eligible for open-market operations) shall be governed with a view to accommodating commerce and business and with regard to their bearing upon the general credit situation of the country.

This language has been in the Federal Reserve Act since 1933 when the Federal Open Market Committee, informally organized in 1923, was made a statutory body.

The objective of "maintaining orderly conditions in the government security market," restated with secondary emphasis in the new policy statement, has no foundation in statute, though the Reserve System has always been attentive to the problems of Treasury financing and in the two world wars made assistance to the vast loan drives its prepossessing concern. The "orderly markets" language was first used publicly in the spring of 1937 when reserve requirement increases, invoked to cut down excess reserves, threw the bond market into turmoil. The Federal Reserve entered the market and, with $200 million purchases of long-term governments, restored order. They again intervened in the market to soften the impact of the outbreak of the war in Europe in September, 1939, and the blow of Pearl Harbor in December, 1941.

The wisdom of these emergency open market operations, in the circumstances, was never seriously questioned. But the easing of an unexpected shock is quite a different sort of thing than the detailed control of prices and trading which has been in effect since the "pattern of rates" technique was adopted in 1942. The experience of the postwar period has taught – not only here but in England, Sweden and elsewhere –that when a central banking system devotes itself to controlling government security prices it reduces its power to control credit. The two things are incompatible.

In time of war, financing the Government's war effort is of course the first essential and in fact the dominating influence on general credit conditions. As we move away from a wartime economy, the responsibility of the Central Banking System shifts and broadens.

Bank Reserves and Money Rates

The new policy implies greater freedom of movement in security prices and yields, and the reserve position of the banks regains a vital importance as a determinant of the cost and availability of credit. The reserve position reflects the ease or difficulty with which banks can take on new loans or investments and, to a considerable extent, the general credit situation. Money rates, and yields on interest-bearing securities, are the

"price" factor in the supply-demand equation of credit and they provided a barometer of the general business and credit situation for generations before the Reserve System was founded.

The reserve position of the member banks of the Federal Reserve System is measured by two elements — their excess reserves and the amount of bills they have discounted with the Reserve Banks. Interest rates tend to rise when excess reserves shrink or bills discounted increase; conversely, they tend to decline when excess reserves increase or bills discounted decrease. The accompanying chart, which goes back twenty years, serves as illustration of how these powerful forces operate. We have today become so used to the pattern of fixed interest rates that it is well to remind ourselves of the more normal play of money market influences.

In the upper block of the chart excess reserves and bills discounted are plotted, the latter on a reversed scale since bills discounted represent deficiencies in reserves covered by borrowings from the Federal Reserve. The lower block of the chart gives yields on Aaa-rated corporation bonds and long-term Treasury bonds, as representative of long-term interest rates, and the average rate at which Treasury bill issues were sold as representative of short-term rates. All the data are monthly averages of daily figures.

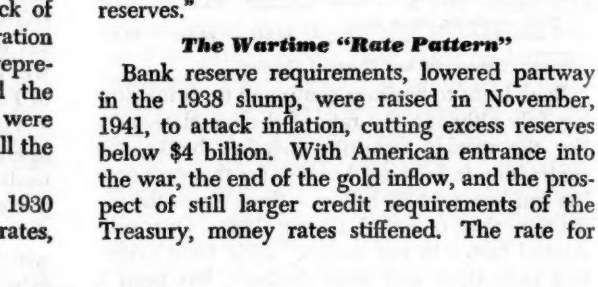
Fluctuations in bank reserve positions in 1930 and 1931, with reflex movements in interest rates, were influenced by a succession of foreign crises, gold movements, drains of currency into hoards, and Treasury deficit financing. Vigorous open market operations by the Reserve Banks, to ease the supply of credit, were delayed until 1932 when passage of the Glass-Steagall Act removed a barrier by permitting the use of government securities as collateral behind Federal Reserve notes. Between February, 1932 and December, 1933 the Federal Reserve Banks added the unprecedented amount of $1.7 billion to their government security holdings. Member banks were able to pay off virtually all their borrowings and excess reserves were run up to around $750 million. This was adjudged "enough" of easy money by the authorities. Open market operations by the Reserve Banks were suspended, save for replacement of maturing obligations, until 1937 and then only were brought into use to cushion a decline in government bond prices.

The Excess Reserve Problem: 1935-41

Under the circumstances of 1934, demands for funds from the Federal Government for financing deficits should have brought some gradual contraction in excess reserves and firming of money rates. As it happened, political and economic disturbances in Europe resulted in an unexampled flow of capital and gold to the United States. The gold, valued at $35 an ounce in comparison with the old $20.67 an ounce, built up bank reserves far faster than they were called into use. Excess reserves piled up to unheard of levels and laid the foundation for "the problem of excess reserves" which became the preoccupying concern of the Federal Reserve authorities for the seven years, 1935 through 1941. Short-term money rates descended to levels which represented little more than the costs involved in acquiring particular classes of paper. Bond prices boomed, save for the shock effects of the 1936-37 increases in bank reserve requirements, as the authorities, fearful of the inflationary implications, grappled with "the problem of excess reserves."

The Wartime "Rate Pattern"

Bank reserve requirements, lowered partway in the 1938 slump, were raised in November, 1941, to attack inflation, cutting excess reserves below $4 billion. With American entrance into the war, the end of the gold inflow, and the prospect of still larger credit requirements of the Treasury, money rates stiffened. The rate for



Member Bank Excess Reserves, Bills Discounted, and Security Yields.

91-day Treasury bills rose from practically nothing at all up to ⅜ per cent. At that point, it was stabilized by the Federal Open Market Committee. In the long-term bond market, the Federal Reserve authorities set up a floor under prices, supporting at par the 2½ per cents that had been issued in October, 1941. Thus the fixed and inflexible "pattern" of interest rates for war financing was born. Banks were urged to invest excess reserves in government securities and the guaranteed minimum prices — underwritten by the tremendous buying power of the Reserve Banks — made it possible for them to do so without serious risk to their depositors. With controlled interest rates and special arrangements for making ⅜ per cent Treasury bills as good as ready cash, the historical relationship between excess reserves and money rates was broken.

Troubles with the pattern of rates began to appear during the later war years, especially from the differential of rates which provided every inducement to holders of short-term governments to sell out and lend the proceeds or shift to long-terms. To ameliorate the inflationary pressures growing out of this situation, the Treasury first sold bonds held for government trust funds. Then in July, 1947 the ⅜ per cent Treasury bill rate was formally "defrosted", and a regulated rise to about 1.15 per cent ensued over a period of eighteen months. Synchronously, the rate offered on one-year certificates was adjusted, from the wartime ⅞ per cent, to 1 per cent, then to 1⅛ per cent, and finally to 1¼ per cent last October.

These anti-inflationary measures, and also the declines in bond prices that were permitted to occur, all had some effectiveness. The rise in rates on short-term governments immensely broadened the market for those classes of securities. But, as bond prices weakened under the developing weight of postwar private borrowing requirements, formal floors of par or better were put under the government bond market to protect the 2½ per cent long-term anchor of the "rate pattern." Under the pegs adopted after some adjustment on Christmas Eve of 1947, the Federal Reserve authorities found themselves in a position where they were successfully maintaining a structure of yields and prices on government securities but were helpless to control the amount of bonds they might be called upon to buy to support that structure. Thus, from November, 1947 through November, 1948, they were buying government bonds and encouraging inflation which everyone was saying should be checked.

When increases in reserve requirements for the member banks were ordered as anti-inflationary measures, the banks raised the funds by selling government securities which the Federal Reserve felt obliged to buy to keep their prices from falling. The general upshot was that large amounts of government securities were forcibly transferred from the member institutions to the Reserve Banks. Neither excess reserves nor security yields were very much affected. The policy of maintaining fixed rates was defeating the more vital anti-inflation policy.

Dilemma in Reverse

Beginning last winter, with the onset of business recession, the authorities had the same dilemma in reverse. The bond market was buoyant and the Federal Reserve was selling bonds to keep prices stable. Under these conditions, as the new policy announcement stated, "the maintenance of a relatively fixed pattern of rates has the undesirable effect of absorbing reserves from the market at a time when the availability of credit should be increased."

Since the adoption of the new policy a month ago, open market operations have been conducted "with primary regard to the general business and credit situation," rather than with primary regard to the maintenance of a preconceived pattern of rates. As this policy has been implemented, the average level of excess reserves has been increased from $750 million to around $950 million in July. The response of market forces is a fresh demonstration of the strength of Federal Reserve powers and the sensitivity of the market organism to the exercise of those powers.

At the current position of excess reserves and of open market money rates, it is clear that banks are eager to lend all the funds they can, and more important still the market for new issues to finance business and government undertakings is receptive. There would appear to be little advantage in seeking a higher level of excess reserves for an even lower structure of money rates. Experience has taught that too many excess reserves, and extremes of cheap money rates, provide little additional stimulation to credit use. And they make more difficult moves in the other direction when business picks up and bank credit expands.

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